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SUBJECT: CYPRUS: 2006-2007 INTERNATIONAL NARCOTICS CONTROL STRATEGY
REPORT (INCSR) PART II, FINANCIAL CRIMES AND MONEY LAUNDERING

REF: STATE 157084

11. Per Reftel request, Post submits in para 2 below Part II (Financial Crimes and Money Laundering) of the 2006-2007 INCSR. The report is based on an update of last year's published version. As requested Reftel, we will also e-mail a track-changes version of this report to the officials requested. We will forward statistics for 2006 on the number of SARS, prosecutions, and freezing and confiscation orders via e-mail when this information becomes available in January.

12. BEGIN TEXT

Cyprus

Cyprus has been divided since the Turkish military intervention of 1974, following a coup d'etat directed from Greece. Since then, the southern part of the country has been under the control of the Government of the Republic of Cyprus. The northern part is controlled by a Turkish Cypriot administration that in 1983 proclaimed itself the "Turkish Republic of Northern Cyprus (TRNC)," recognized only by Turkey. The U.S. Government recognizes only the Government of the Republic of Cyprus, and does not recognize the "TRNC." Government-controlled area.

The government-controlled area of the Republic of Cyprus is a major regional financial center with a robust financial services industry, contributing 6.6 percent to the country's Gross Domestic Product. Like other such centers, it remains vulnerable to international money laundering activities. Fraud and, to some extent, narcotics trafficking are the major sources of illicit proceeds laundered in Cyprus. Casinos, Internet gaming sites, and bearer shares are not permitted, although sports betting halls are allowed.

The development of the financial sector in Cyprus has been facilitated by the island's central location, a preferential tax regime, double tax treaties with 40 countries (including the United States, several European Union (EU) nations, and former Soviet Union nations), a labor force particularly well trained in legal and accounting skills, a sophisticated telecommunications infrastructure, and relatively liberal immigration and visa requirements. In recent years, Cyprus has introduced tax and legislative changes effectively abolishing all legal and substantive

distinctions between domestic and offshore companies. All Cypriot companies are now taxed at a uniform rate of 10 percent, irrespective of the permanent residence of their owners or whether they do business internationally or in Cyprus. A transition period allowing preferential tax treatment to offshore companies that existed prior to 2002 expired on January 1, 2006. Additionally, the prohibition from doing business domestically has been lifted and companies formerly classified as offshores are now free to engage in business locally.

Over the past decade, Cyprus has put in place a comprehensive anti-money laundering legal framework. The GOC continues to revise these laws to meet evolving international standards. In 1996, the GOC passed the Prevention and Suppression of Money Laundering Activities Law, which mandated the establishment of a Financial Intelligence Unit (FIU). This law criminalizes both drug and non-drug-related money laundering, provides for the confiscation of proceeds from serious crimes, and codifies the actions that banks, non-bank financial institutions, and non-financial businesses (including lawyers, accountants, real estate agents, and dealers in precious metals and stones) must take (including customer identification). The anti-money laundering law authorizes criminal (but not civil) seizure and forfeiture of assets. Subsequent amendments to the 1996 law broadened its scope by eliminating the separate list of predicate offenses (now defined as any criminal offense punishable by a prison term exceeding one year), addressing government corruption, and facilitating the exchange of financial information with other FIUs, as well as the sharing of assets with other governments. A law passed in 1999 criminalizes counterfeiting bank instruments, such as certificates of deposit and notes.

Amendments passed in 2003 and 2004 implement the EU's Second Money Laundering Directive. These amendments authorize the FIU to instruct banks to delay or prevent execution of customers' payment

orders; extend due diligence and reporting requirement to auditors, tax advisors, accountants, and, in certain cases, attorneys, real estate agents, and dealers in precious stones and gems; permit administrative fines of up to \$6,390; and increase bank due diligence obligations concerning suspicious transactions and customer identification requirements, subject to supervisory exceptions for specified financial institutions in countries with equivalent requirements.

Also in 2003, the GOC enacted new legislation regulating capital and bullion movements and foreign currency transactions. The new law requires all persons entering or leaving Cyprus to declare currency (whether local or foreign) or gold bullion worth approximately \$15,500 or more. This sum is subject to revision by the Central Bank. This law replaces exchange control restrictions under the Exchange Control Law, which expired on May 1, 2004.

Financial institutions in Cyprus are regulated and supervised by four authorities: the Central Bank of Cyprus, responsible for supervising locally incorporated banks as well as subsidiaries and branches of foreign banks; the Cooperative Societies Supervision and Development Authority (CSSDA), supervising cooperative credit institutions; the Superintendent for Insurance Control; and the Cyprus Securities and Exchange Commission. Designated non-financial businesses and professions (DNFBP) are supervised as follows: attorneys are supervised by the Council of the Bar Association; accountants are supervised by the Institute of Certified Public Accountants; and real estate agents and dealers in precious metals and stones are supervised by the local FIU. The supervisory authorities may impose administrative sanctions if the legal entities or persons they supervise fail to meet their obligations as prescribed in Cyprus's anti-money laundering laws and regulations.

The Government-controlled area of Cyprus currently hosts a total of 40 banks: 14 locally-incorporated, of which 11 are commercial banks and three are specialized financial institutions. Of the commercial banks, six are foreign-owned, and two are branches of foreign banks.

The remaining 26 are foreign-incorporated banks that conduct their operations almost exclusively outside of Cyprus. At the end of August 2006, the cumulative assets of domestic banks were \$53.9 billion, while the cumulative assets of subsidiaries and branches of the foreign-incorporated banks were \$22.8 billion.

Since May 2004, when Cyprus joined the EU, banks licensed by competent authorities in EU countries may establish branches in Cyprus or provide banking services on a cross-border basis without obtaining a license from the Central Bank of Cyprus, under the EU's "single passport" principle. By the end of 2006, four EU banks were operating a branch in Cyprus under the "single passport" arrangement. Cyprus hosts six licensed money transfer companies, 40 international independent financial advisers, six international trustee services and 200 feeder funds. There are also 47 investment firms, two UCITS management firms, 43 licensed insurance companies, 238 licensed real estate agents, 1,858 registered accountants, 1,631 practicing lawyers and around 350 credit institutions.

In October 2006, the IMF released a detailed assessment of the "Observance of Standards and Codes for Banking Supervision, Insurance Supervision and Securities Regulation." Among other things, the report noted that the SEC was legally unable to cooperate with foreign regulators if the SEC did not have an independent interest in the matter being investigated, and that the SEC was experiencing difficulty obtaining information regarding the beneficial owners of Cypriot-registered companies. The SEC is working to resolve both of these issues. The report also noted that commitments emerging from EU accession had "placed stress on the skills and resources" of the staff of the CSSDA and the Insurance Superintendent and recommended additional training.

In recent years the Central Bank has introduced many new regulations aimed at strengthening anti-money laundering vigilance in the banking sector. Among other things, banks are required to (1) ascertain the identities of the natural persons who are the "principal/ultimate" beneficial owners of corporate or trust accounts; (2) obtain as quickly as possible identification data on the natural persons who are the "principal/ultimate" beneficial owners when certain events occur, including an unusual or significant transaction or change in account activity; a material

change in the business name, officers, directors and trustees, or business activities of commercial account holders; or a material change in the customer relationship, such as establishment of new accounts or services or a change in the authorized signatories; (3) adhere to the October 2001 paper of the Basel Committee on Banking Supervision on "Customer Due Diligence for Banks"; and (4) pay special attention to business relationships and transactions involving persons from jurisdictions identified by the Financial Action Task Force (FATF) as non-cooperative. This list is updated regularly in line with the changes effected to the list of non-cooperative countries and territories by the FATF.

All banks must report to the Central Bank, on a monthly basis, individual cash deposits exceeding approximately \$21,200 in local currency or approximately \$10,000 in foreign currency. Bank employees currently are required to report all suspicious transactions to the bank's compliance officer, who determines whether to forward the report to the Unit for Combating Money Laundering (MOKAS), the Cypriot FIU, for investigation. Banks retain reports not forwarded to MOKAS, and these are audited by the Central Bank as part of its regular on-site examinations. Banks must file monthly reports with the Central Bank indicating the total number of suspicious activity reports (SARs) submitted to the compliance officer, and the number forwarded by the compliance officer to MOKAS. By law, bank officials may be held personally liable if their institutions launder money. Cypriot law partially protects reporting individuals with respect to their cooperation with law enforcement but does not clearly absolve a reporting institution or its personnel from complete criminal or civil liability. Banks must retain transaction records for five years.

In November 2004, the Central Bank issued a revised money laundering guidance note that places several significant new obligations on banks, including requirements to develop a customer acceptance policy; renew customers' identification data on a regular basis; construct customers' business profiles; install computerized risk management systems in order to verify whether a customer constitutes a "politically exposed person"; provide full details on any customer sending an electronic transfer in excess of \$1,000; and implement (by June 5, 2005) adequate management information systems for on-line monitoring of customers' accounts and transactions. Cypriot banks have responded by adopting dedicated electronic risk

management systems, which they typically use to target transactions to and from high-risk countries. Cyprus's Exchange Control Law expired on May 1, 2004, ending Central Bank review of foreign investment applications for non-EU residents. Individuals wishing to invest on the island now apply through the Ministry of Finance. The Ministry also supervises collective investment schemes.

The Central Bank also requires compliance officers to file an annual report outlining measures taken to prevent money laundering and to comply with its guidance notes and relevant laws. In addition, the Central Bank is legally empowered to conduct unannounced inspections of bank compliance records. In July 2002, the U.S. Internal Revenue Service (IRS) officially approved Cyprus's "know-your-customer" rules, which form the basic part of Cyprus' anti-money laundering system. As a result of the above approval, banks in Cyprus that may be acquiring United States securities on behalf of their customers are eligible to enter into a "withholding agreement" with the IRS and become qualified intermediaries.

MOKAS, the Cypriot FIU, was established in 1997. MOKAS is responsible for receiving and analyzing SARs and for conducting money laundering or financial fraud investigations. A representative of the Attorney General's Office heads the unit. In June 2006, MOKAS hired an additional six financial investigators, giving it a permanent staff of 20. MOKAS cooperates closely with FinCEN and other U.S. Government agencies in money laundering investigations.

All banks and non-bank financial institutions, insurance companies, the stock exchange, cooperative banks, lawyers, accountants, and other financial intermediaries must report suspicious transactions to MOKAS. Sustained efforts by the Central Bank and MOKAS to strengthen reporting have resulted in an increase in the number of SARs being filed from 25 in 2000 to 168 in 2005. During 2005, MOKAS received 206 information requests from foreign FIUs, other foreign authorities, and INTERPOL. Nine of the information requests were

related to terrorism, although not specifically involving Cyprus. MOKAS evaluates evidence generated by its member organizations and other sources to determine if an investigation is necessary. It has the power to suspend financial transactions for an unspecified period of time as an administrative measure. MOKAS also has the power to apply for freezing or restraint orders affecting any kind of property at a very preliminary stage of an investigation. In 2005, for the first time, MOKAS issued several warning notices, based on its own analysis, identifying possible trends in criminal financial activity. These notices have already produced results, including the closure of dormant bank accounts. MOKAS conducts anti-money laundering training for Cypriot police officers, bankers, accountants, and other financial professionals. Training for bankers is conducted in conjunction with the Central Bank of Cyprus. Since late 2003, the MOKAS computer network has been connected with that of the central government, thus giving MOKAS direct access to other GOC agencies and ministries.

During 2005, MOKAS opened 388 cases and closed 188. Reportedly, there was an undetermined number of successful prosecutions. During the same period, it issued 17 Information Disclosure Orders (typically involving judiciary proceedings in courts abroad), 12 administrative orders for postponement of transactions, and nine freezing orders, resulting in the freezing of \$1,680,000 in bank accounts and 11 pieces of real estate. Additionally, during 2005, MOKAS issued two confiscation orders for a total amount of \$42,000 (in one of the cases, the GOC shared the money with another jurisdiction that had been involved). Government actions to seize and forfeit assets have not been politically or publicly controversial, nor have there been retaliatory actions related to money laundering investigations, cooperation with the United States, or seizure of assets. There have been at least ten convictions recorded under the 1996 Anti-Money Laundering law, and a number of other cases are pending.

On November 30, 2001, Cyprus became a party to the UN International Convention for the Suppression of the Financing of Terrorism. The implementing legislation amended the anti-money laundering law to criminalize the financing of terrorism. The parliament passed an amendment to the implementing legislation in July 2005 eliminating a

loophole that had inadvertently excused Cypriot nationals operating in Cyprus from prosecution for terrorism finance offenses. Cyprus has yet to criminalize, however, collecting funds in the knowledge that they are to be used for any purpose by a terrorist organization or an individual terrorist, as required by FATF Special Recommendation II. In November 2004, MOKAS designated two employees to be responsible for terrorism finance issues. MOKAS routinely asks banks to check their records for any transactions by any person or organization designated by foreign FIUs as a terrorist or a terrorist organization. If a person or entity is so designated by the UN 1267 Sanctions Committee or the EU Clearinghouse, the Central Bank automatically issues a "search and freeze" order to all banks, both domestic and IBUs. As of November 2006, no bank had reported holding a matching account. The lawyers' and accountants' associations cooperate closely with the Central Bank. The GOC cooperates with the United States to investigate terrorist financing.

There is no evidence that alternative remittance systems such as hawala or black market exchanges are operating in Cyprus, at least on a significant scale. The GOC believes that its existing legal structure is adequate to address money laundering through such alternative systems. The GOC licenses charitable organizations, which must file with the GOC copies of their organizing documents and annual statements of account. Reportedly, the majority of all charities registered in Cyprus are domestic organizations.

Cyprus is a party to the 1988 UN Drug Convention and the UN Convention against Transnational Organized Crime. Cyprus is a member of the Council of Europe's MONEYVAL, and the Offshore Group of Banking Supervisors. MOKAS is a member of the Egmont Group and has signed memoranda of understanding (MOUs) with the FIUs of the United States, Belgium, France, the Czech Republic, Slovenia, Malta, Ireland, Australia, Ukraine, Poland, Canada, Russia, Bulgaria, South Africa, and Israel and Romania. Although Cypriot law specifically allows MOKAS to share information with other FIUs without benefit of an MOU, Cyprus is negotiating MOUs with Venezuela, and Italy. A Mutual Legal Assistance Treaty between Cyprus and the United States

entered into force September 18, 2002. In 1997, the GOC entered into a bilateral agreement with Belgium for the exchange of information on money laundering. Cyprus underwent a MONEYVAL mutual evaluation in April 2005, the results of which were published in a report adopted at the MONEYVAL Plenary meeting in January 2006. The report found Cyprus at least partially compliant with all 40 of the Financial Action Task Force's (FATF) Recommendations and all nine of FATF's Special Recommendations on terrorism finance. It also put forward a detailed recommended action plan designed to help Cyprus further improve its anti-money laundering system.

The Government of the Republic of Cyprus has put in place a comprehensive anti-money laundering regime. It should continue to take steps to tighten implementation of its laws. In particular, it should enhance regulation of corporate service providers, including trust and incorporation companies, lawyers, accountants, and other designated non-financial businesses and professions. It should criminalize collecting funds in the knowledge that they will be used by terrorist organizations or individual terrorists. It should enact provisions that allow for civil forfeiture of assets. Cyprus should also take steps to implement the recommendations of the recent MONEYVAL and IMF evaluations.

Area Administered by Turkish Cypriots.

The Turkish Cypriot community continues to lack the legal and institutional framework needed to provide effective protection against the risks of money laundering. Turkish Cypriot authorities have, however, developed a greater appreciation of the dangers of unchecked money laundering and have begun taking limited steps to address these risks. Nevertheless, it appears that the Turkish Cypriot leadership lacks the political will necessary to push through reforms needed to introduce effective oversight of its limited and relatively isolated financial sector. It is believed that the 23 essentially unregulated, and primarily Turkish-mainland owned, casinos, and the 16 offshore banks, are the primary vehicles through which money laundering occurs. Casino licenses are fairly easy to obtain, and background checks done on applicants are minimal. A significant part of the funds generated by these casinos

reportedly change hands in Turkey without ever entering the Turkish Cypriot banking system, and there are few safeguards to prevent the large-scale transfer of cash to Turkey. Another area of concern is the roughly 500 "finance institutions" operating in the area administered by Turkish Cypriots that extend credit and give loans. Although they must register with the "Office of the Registrar of Companies," they are unregulated. Some are owned by banks and others by auto dealers. In 2005 and 2006, there was a huge increase in the number of sport betting halls, which are licensed by the "Prime Minister's Office." There are currently 7 companies operating in this sector, with a total of 85 outlets. Four of the companies also accept bets over the internet. The fact that the "TRNC" is recognized only by Turkey limits the ability of Turkish Cypriot officials to receive training or funding from international organizations with experience in combating money laundering. The Turkish Cypriot community is not part of any regional FATF-style organization and thus is not subject to any peer evaluations.

The offshore banking sector also remains a concern. In August 2004, the U.S. Department of the Treasury's FinCEN issued a notice of proposed rule making to impose a special measure against First Merchant Bank OSH Ltd in the area administered by Turkish Cypriots as a financial institution of primary money laundering concern. Pursuant to Section 311 of the USA PATRIOT Act, FinCEN found First Merchant Bank to be of primary money laundering concern based on a number of factors, including: (1) it is licensed as an offshore bank in the "TRNC", a jurisdiction with inadequate anti-money laundering controls, particularly those applicable to its offshore sector; (2) it is involved in the marketing and sale of fraudulent financial products and services; (3) it has been used as a conduit for the laundering of fraudulently obtained funds; and (4) the individuals who own, control, and operate First Merchant Bank have links with organized crime and apparently have used First Merchant Bank to launder criminal proceeds. As a result of the finding and in consultation with federal regulators and the Departments of Justice and State, FinCEN proposed imposition of the special measure that would prohibit the opening or maintaining of correspondent or payable-through accounts by any domestic financial institution or domestic financial agency for, or on behalf of, First Merchant Bank

OSH Ltd. The Turkish Cypriot authorities have not revoked or suspended First Merchant Bank's license, and it continues to operate.

In 1999, a money laundering law for the area administered by Turkish Cypriots went into effect with the stated aim of reducing the number of cash transactions in the "TRNC" as well as improving the tracking of any transactions above \$10,000. Banks are required to report to the "Central Bank" any electronic transfers of funds in excess of \$100,000. Such reports must include information identifying the person transferring the money, the source of the money, and its destination. Banks, non-bank financial institutions, and foreign exchange dealers must report all currency transactions over \$20,000 and suspicious transactions in any amount. Banks must follow a know-your-customer policy and require customer identification. Banks must also submit suspicious transaction reports to an "Anti-Money Laundering Committee" that is supposed to function as a quasi-FIU and have investigative powers. The five-member committee is composed of representatives of the police, customs, the "Central Bank," and the "Ministry of Finance." However, the 1999 anti-money laundering law has never been fully implemented or enforced.

In 2005, the "Anti-Money Laundering Committee," which had been largely dormant for several years, began meeting on a regular basis and encouraging banks to meet their obligations to file SARs. The committee has reportedly referred several cases of possible money laundering to law enforcement for further investigation, but no cases have been brought to court and no individuals have been charged. There have been no successful prosecutions of individuals on money laundering charges, although one foreign bank owner suspected of having ties to organized crime was successfully extradited. There are significant concerns that law enforcement and judicial officials lack the technical skills needed to investigate and prosecute financial crimes.

Although the 1999 money laundering law prohibits individuals entering or leaving the area administered by Turkish Cypriots from transporting more than \$10,000 in currency without prior "Central

Bank" authorization, "Central Bank" officials note that this law is difficult to enforce, given the large volume of travelers to and from Turkey. In 2003, Turkish Cypriot authorities relaxed restrictions that limited travel across the UN-patrolled buffer zone. There is also a relatively large British population in the area administered by Turkish Cypriots and a significant number of British tourists. As a result, an informal currency exchange market has developed.

The "Ministries of Finance and Economy and Tourism" are drafting several new anti-money laundering laws that they say will, among other things, establish an FIU and better regulate casinos, currency exchange houses, and both onshore and offshore banks. Turkish Cypriot officials have committed to ensuring that the new legislation meets international standards. However, it is unclear if and when the new legislation will be adopted, and if it is, whether it will ever be fully implemented and enforced. Work on the new bills has already taken over two years.

There are currently 24 domestic banks in the area administered by Turkish Cypriots. Internet banking is available. The offshore sector consists of 16 banks and approximately 50 companies. The offshore banks may not conduct business with residents of the area administered by Turkish Cypriots and may not deal in cash. The offshore entities are audited by the "Central Bank" and are required to submit a yearly report on their activities. However, the "Central Bank" has no regulatory authority over the offshore banks and can neither grant nor revoke licenses. Instead, the "Ministry of Finance" performs this function. Although a proposed new law would have restricted the granting of new bank licenses to only those banks already having licensees in an OECD country, the law never passed.

The 1999 Turkish Cypriot anti-money laundering law does provide better banking regulations than were previously in force, but it is far from adequate. The major weakness continues to be the many casinos, where a lack of resources and expertise leave that area, for all intents and purposes, unregulated, and therefore especially vulnerable to money laundering abuse. The largely unregulated finance institutions, currency exchange houses, and offshore banking

sector are also of concern. The Turkish Cypriot authorities should move quickly to enact a new anti-money laundering law, establish a strong and functioning financial intelligence unit, and tighten regulation of casinos, money exchange houses, and the offshore sector.

END TEXT

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